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In the
Supreme Court of the United States

October Term, 1970

No.

BRUNSWICK CORPORATION,

Petitioner,

vs.

HOWELL W. CLEMMITT,
Trustee in Bankruptcy for Olympic Lanes, Inc.,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner Brunswick Corporation respectfully requests this Court to issue a writ of certiorari to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered on April 17, 1970.

OPINIONS BELOW

The opinion of the Court of Appeals, not yet reported, appears in the Appendix hereto. No opinion was rendered by the District Court for the Eastern District of Tennessee, Southern Division. Its Judgment Order is printed in the Appendix.

JURISDICTION

The judgment of the Court of Appeals was entered April 17, 1970. A timely petition for rehearing was denied June 8, 1970. An application for extension of time in which to file a petition for a writ of certiorari until October 8, 1970 was granted by Mr. Justice Stewart on August 28, 1970. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

After Olympic Lanes, Inc. (the respondent's bankrupt) had defaulted on payments to petitioner Brunswick Corporation for pinsetters, bowling lanes and related equipment, Brunswick brought a replevin action against Olympic to recover possession of the bowling equipment. In repossessing the bowling equipment Brunswick took over (by lease from the owner of the premises) the bowling center and also some of Olympic's personal property (office and dining furniture, built-in and other equipment, machinery, and carpeting) which Olympic had not removed from the bowling center when it surrendered the premises to its landlord. Despite several requests from Brunswick that the property be removed, Olympic failed to do so and Brunswick put the property in storage. Olympic counterclaimed for damages for conversion and Brunswick counterclaimed for its deficiency balance due on the contracts. Brunswick obtained summary judgment on its claim and a jury entered a verdict for Olympic on its claim for conversion. The Court of Appeals refused to allow the District Court's set-off of Brunswick's larger recovery against the $40,000.00 verdict in favor of Olympic.

The questions presented are:

1. Whether the Court of Appeals was correct in ruling that, as a matter of law, under Section 68 of the Bank-

ruptcy Act an indisputably valid judgment may not be set-off against a creditor's liability to a bankrupt estate for conversion, no matter how innocent the conversion was in fact.

2. Whether under Section 68(b) of the Bankruptcy Act a judgment rendered in favor of a creditor on its counterclaim may be set off from a judgment rendered against the creditor on the bankrupt's claim for conversion which occurred more than one year prior to the bankruptcy.

STATUTE INVOLVED

Section 68 of the Bankruptcy Act (11 U.S.C. § 108), entitled "Set-offs and counterclaims," reads as follows:

> a. In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set off against the other, and the balance only shall be allowed or paid.
>
> b. A set-off or counterclaim shall not be allowed in favor of any debtor of the bankrupt which (1) is not provable against the estate and allowable under subdivision g of section 93 of this title; or (2) was purchased by or transferred to him after the filing of the petition or within four months before such filing, with a view to such use and with knowledge or notice that such bankrupt was insolvent or had committed an act of bankruptcy.

STATEMENT OF THE CASE

The jurisdiction of the District Court was invoked because of diversity of citizenship, the petitioner being a citizen of Delaware and Illinois and the defendants being citizens of Tennessee. However, on appeal the case turned on the interpretation of Section 68 of the Bankruptcy Act, 11 U.S.C. §108, referred to herein as Section 68.

In 1961 Brunswick Corporation sold bowling equipment to Olympic Lanes, Inc. As security for the indebtedness Brunswick held conditional sales contracts and notes covering the bowling equipment and a chattel mortgage covering snack bar equipment. All of the secured property was installed in Olympic's bowling center located in a leased building in Chattanooga, Tennessee. Between 1961 and September, 1966, Olympic paid only a small proportion of the amount due under its contracts, and at the end of that period Olympic owned Brunswick $548,679.58.

On September 2, 1966 Brunswick filed a replevin action with bond in the District Court and the U. S. Marshal took possession of the bowling equipment. Olympic had also defaulted on its lease, voluntarily surrendering possession of the bowling center premises to its landlord. Thereafter, Brunswick, having obtained a lease from the landlord, legally came into possession of the premises on or about September 9, 1966. When Brunswick took possession of the bowling center it also, necessarily, took possession not only of the equipment in which it had a security interest, but also of other personal property which Olympic had failed to remove from the bowling center when it surrendered the premises to its landlord. Although this latter property was owned by Olympic, it was secured by a chattel mortgage held by another of Olympic's creditors. It was this property which was later found to have been converted by Brunswick.

On September 20, 1966 Olympic filed its answer and counterclaim, seeking among other things compensatory and punitive damages for Brunswick's conversion of its property. The District Court thereafter entered summary judgment for Brunswick in the replevin action, and the bowling equipment was sold at public auction to Brunswick,

thereby reducing Olympic's indebtedness to $324,006.43. Brunswick, by its own counterclaim, then sought to recover the deficiency balance from Olympic. Thereafter, on November 14, 1967, Olympic filed a voluntary petition in bankruptcy and the respondent, Howell W. Clements, as trustee in bankruptcy ("Trustee"), was substituted as the party defendant and counter-plaintiff in the lawsuit.

Upon the trial the District Court entered summary judgment for Brunswick on its claim for the deficiency balance due from Olympic and for attorney's fees in the total sum of $356,407.07. The only issue which was contested on the trial was Olympic's conversion claim.

The undisputed evidence showed the following: Although Brunswick did use some of Olympic's property for a short period of time, Olympic's President, Mr. L. B. Jackson, had a key to the premises and had every opportunity to remove any of Olympic's personal property to which Brunswick had no claim. (Tr. 92-93). Brunswick inventoried all of Olympic's property, and segregated most of it in a separate room. (Tr. 275). By letter and telephone call, on numerous occasions, Olympic was specifically requested to remove the property. This Olympic refused or neglected to do, except as to a few items which Mr. Jackson selected. Olympic encountered no obstacle to the removal of any or all of this property. Neither Mr. Jackson nor his attorneys ever demanded or requested that Brunswick return any property to the debtor. Mr. Jackson admitted that he had never been denied access to the premises or denied the right to obtain the property. (Tr. 92-99, 107-108). Brunswick later placed Olympic's property in storage at a cost to Brunswick of $25.00 per month.

The District Court had indicated to counsel during a chambers hearing that the following instruction would be given to the jury on the punitive damage issue (Tr. 271):

> "Punitive damages are not allowable unless you find that the conversion was done willfully or maliciously or in the reckless disregard of Olympic's rights."

Thereafter, prior to submitting the case to the jury, the District Court determined as a matter of law that Brunswick could not be liable for punitive damages. Thus the District Court found that the conversion was not willful or malicious or in reckless disregard of Olympic's rights.

The jury, however, found that Brunswick was guilty of conversion and entered a verdict for $40,000.00.* In entering final judgment the District Court offset the $356,407.07 summary judgment previously awarded to Brunswick against the $40,000.00 verdict for the Trustee with the result that Brunswick received judgment for $316,407.07. The Trustee appealed the judgment thus entered by the District Court.

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* The District Court had instructed the jury that a "conversion may be found when someone other than the owner exercises dominion over the property." (Tr. 339-340). This instruction was consistent with the court's ruling that Brunswick was not guilty of a *willful* conversion. Moreover, the court had expressed doubt that Brunswick was guilty of even a technical conversion. In ruling on a motion for a directed verdict at the close of the Trustee's case, the District Judge stated that there was serious doubt whether there was any liability at all on the conversion question. (Tr. 247). In view of what Brunswick thought was its clear right of set-off, and Olympic's insolvency, Brunswick did not appeal from the conversion judgment.

The Court of Appeals reversed, stating that set-offs were only permissive and must be granted or denied in accordance with equitable principles, and that a creditor who converts the property of his debtor with knowledge of the debtor's insolvency is not permitted to set-off his conversion liability. A petition for rehearing was thereafter denied.*

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* Brunswick subsequently filed motions with the District Court requesting that the Court hold further hearings on the issues of (1) willfulness of the conversion and (2) whether other creditors were prejudiced. The District Court, in denying the motion, stated:

> "The Court of Appeals vacated this Court's order granting the set-off. We are advised that a petition for rehearing was filed but denied. The Court of Appeals stated that the 'only issue is whether a conversion judgment against a creditor of the bankrupt can be set off from money owed the creditor by the bankrupt which arose under a contract.' It was specifically held that conversion liability may not be set off against contract claims. In the light of this holding, the question of whether there was a willful conversion on the part of Brunswick or whether Brunswick in effect paid itself by the Conversion at the expense of other creditors was not pertinent.
>
> We are bound by the decision of the Court of Appeals." (Order of August 11, 1970.)

Brunswick has appealed from this order of the District Court.

REASONS FOR GRANTING THE WRIT

Under the decision below Brunswick must pay respondent $40,000, most of which is likely to go for expenses of the bankruptcy estate, despite the fact that the bankrupt owes Brunswick $356,407.07.

The doctrine of set-off embodied in Section 68(a) of the Bankruptcy Act, and the doctrine of counterclaim recognized as generally applicable in Section 68(b) of the Bankruptcy Act, are designed to avoid unfairness of this kind. Although the result under these doctrines is to give the creditor with the set-off or counterclaim an advantage over other creditors, equity courts have long permitted this type of preference rather than require a creditor to pay an insolvent debtor who owes him a larger sum.

Although Section 68 has been held to embody the principles of equitable set-off, that has not meant that set-off is to be barred in the absence of fraud, bad faith or a violation of statutory policy. The Court of Appeals held that a creditor who converts the property of his debtor, whether in bad faith or not, is not equitably entitled to set-off under Section 68. In the event of an innocent conversion, as in the present case, this result leads to gross injustice and, we submit, is inconsistent with other cases denying set-off on equitable principles. The question of how far the courts are to depart from the clear language of Section 68 in denying set-off is an important question which this Court should resolve.

I. THE DECISION BELOW MISINTERPRETS AN IMPORTANT PROVISION OF THE BANKRUPTCY ACT.

Section 68(a) of the Bankruptcy Act provides that mutual debts between the estate of the bankrupt and a credi-

tor "shall be" set-off, and the balance only shall be allowed or paid. This section is the statutory enactment of the doctrine of equitable set-off. *Cumberland Glass Mfg. Co.* v. *DeWitt*, 237 U.S. 447 (1915). In enacting Section 68(a) Congress determined that the equity of allowing a creditor who is also a debtor of a bankrupt to set-off his indebtedness to the bankrupt, rather than pay his debt in full and receive less than full payment from the bankrupt, was superior to the equity of treating all creditors of the bankrupt alike. Thus, despite the fact that set-off has the inevitable effect of preferring one creditor over other creditors, that result is permitted and encouraged by the Bankruptcy Act. Set-off under Section 68(a) is a "lawful preference." *In re Pottier & Stymus Co.*, 262 Fed. 955 (2d Cir., 1919); 3 Remington, *Bankruptcy* (Rev. Ed., 1957) § 1434.5, pp. 376-77.

Section 68(b) of the Bankruptcy Act prohibits set-off in only two situations. It provides that a set-off or counterclaim will not be allowed when the transaction giving rise to it occurred within four months of bankruptcy and when the debtor was insolvent, or if the set-off or counterclaim was purchased by or transferred to the creditor within four months of bankruptcy with a view to such use and with knowledge of the debtor's insolvency. Thus, a set-off or counterclaim is prohibited when the underlying transaction is, in legal effect, a voidable preference.

Despite the mandatory statutory language creating the right of set-off and the fact that specific restrictions are stated in the statute, courts have consistently held that set-off may be denied on general equitable principles. E.g., *Cumberland Glass Mfg. Co.* v. *DeWitt*, *supra*. However, this does not mean that set-off can be denied on the ground that the creditor claiming the set-off is not entitled to achieve a preference over other creditors. For such a preference is inherent in the doctrine of set-off, and Con-

gress has decreed that such a result is fair so long as no voidable preference is involved.*

Since set-off itself imports equity, set-off is allowed unless specifically prohibited by Section 68(b) or where the set-off would result in manifest inequity. When the transaction providing the basis for the set-off occurs *outside* the four month preference period, principles of equity are imposed to deny set-off which would work a serious injustice. Black, *Bankruptcy*, § 544, p. 1131 (3rd Ed., 1922), cited by this Court in *Cumberland Glass Mfg. Co.* v. *DeWitt, supra*, indicates, for example, that set-off cannot be allowed where the transaction out of which it arose was fraudulent. See also *Palmer* v. *Stokely*, 259 F. Supp. 776 (W.D. Okla., 1966); *Palmer* v. *Doull Miller, Co., Inc.*, 233 Fed. 309 (S.D.N.Y., 1916).

When (outside of the statutory 4-month period) a person claiming set-off "takes" the property of the debtor through a trespass (which is the real property equivalent of conversion for personal property), set-off has been denied only when the trespass has been willful or in bad faith. *Stanolind Oil & Gas Co.* v. *Logan*, 92 F.2d 28 (C.A. 5, 1937); cf., *Gulf Refinery Company* v. *United States*, 269 U.S. 125, 137 (1925), allowing recoupment for unlawful conduct in "moral good faith." In determining whether a trespasser is an innocent or willful trespasser, the following test was suggested by the Court in *United States* v. *Homestake Mining Co.*, 117 Fed. 481, 485-86 (8th Cir., 1902):

> "Every trespasser breaks the law, and to every trespasser the maxim applies that every man knows the

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* *In re Interstate Record Distributors, Inc.*, 307 F. Supp. 1142, 1145 (S.D.N.Y., 1970); *New York County National Bank* v. *Massey*, 192 U.S. 138, 147 (1904); *In re Field Heating & Ventilating Co.*, 201 F.2d 316, 318 (7th Cir., 1953).

law. Notwithstanding all this, the law, in its wisdom, perceives the marked difference in the heinousness of the offenses of those who recklessly, or with actual intention to rob others of their rights, trespass upon their property, and of those who trespass by mistake, and with no evil purpose, no actual, willful intent to commit a wrong. . . . The question, then, is, did the trespasser violate the law, which he constructively knew, recklessly, or with an actual intent to do so, and to take an unconscientious advantage of his victim, or did he violate it inadvertently, unintentionally, or in the honest belief that he was exercising his own right? If the former, he was a willful trespasser. . . . If the latter, he was an innocent trespasser."

A similar distinction should determine whether a conversion bars a set-off under Section 68. In reversing the District Court here, the Court of Appeals relied on what it deemed to be an equity rule that a converter is not entitled to a preference. However, the authorities are consistent in holding that the mere fact that a set-off results in a preference is not grounds for denying set-off. Thus the sole remaining ground for denying the set-off was that Brunswick was a converter. As appears from the undisputed evidence and the District Court's conclusion that Brunswick had not acted willfully or maliciously or in reckless disregard of Olympic's rights (*supra*, p. 6), the conversion here did not rise to the level of inequity which warranted refusing Brunswick its right to set-off.

Although Brunswick had knowledge of Olympic's insolvency long in advance of the conversion, Brunswick did not convert Olympic's property with an intent to keep it or to use it to "pay" Olympic's debt to Brunswick. On the contrary Brunswick did its best to induce Olympic to come and take its property away.

The Court of Appeals seems to have assumed that because a converter knows what he is doing, his conduct is

therefore necessarily wrongful and inequitable. Of course, the entry of any judgment against a defendant establishes that he has acted contrary to the law, and therefore wrongfully; if this were sufficient to prevent a set-off, there could never be a set-off in any circumstances. But as the trespass cases show, a distinction can and should be drawn between an innocent, technical conversion and a willful taking of another's property in determining whether set-off should be denied. This the Court of Appeals failed to do, although the Court noted that Collier "acknowledges that liability for *willful* conversion may not be setoff against a debt owed to the creditor." (Emphasis supplied.) (App. 8.) The Court of Appeals decision conflicts with the principles of the cases (e.g., *Stanolind*, *supra*) requiring fraud, morally unsound conduct, bad faith or willful misconduct before denying set-off on equitable grounds.

To buttress the denial of the set-off under the "equity rule" found by the Court, the Court of Appeals cited a "line of cases which hold that a setoff should not be allowed when the creditor wishes to set off its conversion liability to the bankrupt against a debt owed the creditor by the bankrupt." (App. 9-10.) None of the cases cited by the Court of Appeals involved a conversion which occurred more than four months before the bankruptcy. The leading cases in this Court and the courts of appeals rested on the fact that "the conversion . . . took place after appellant had knowledge of the insolvency of the bankrupts, and within four months preceding the filing of the petitions and adjudications in bankruptcy."* Set-offs for such conversions are, of course, barred under Section 68(b), which prohibits set-off of a claim which would constitute a voidable preference. Therefore, these cases do not support the decision of the Court of Appeals.

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* *Western Tie and Timber Co.* v. *Brown*, 196 U.S. 502 (1905); *Arkansas Fuel Oil Co.* v. *Leisk*, 133 F.2d 79, 80 (5th Cir., 1943).

II. A COUNTERCLAIM WHICH IS PROPER UNDER RULE 13 OF THE FEDERAL RULES OF CIVIL PROCEDURE CAN EFFECT A SET-OFF IN BANKRUPTCY IF THE COUNTERCLAIM IS NOT PROHIBITED UNDER SECTION 68(b) OF THE BANKRUPTCY ACT.

The Court of Appeals, in denying Brunswick's Petition for Rehearing, rejected the argument that Brunswick's *counterclaim* could provide the basis for the judgment entered by the District Court.

Under Rule 13(c) of the Federal Rules of Civil Procedure, a counterclaim can be used to diminish or defeat the recovery sought by the opposing party. When a counterclaim is pleaded, it becomes a part of a single controversy between the parties, requiring only one verdict and one judgment; the general rule is that where an established counterclaim exceeds what is claimed and established by the opposing party the defendant has judgment for the excess. 20 Am. Jur. 2d "Counterclaim, Recoupment, and Setoff," § 157, p. 364.

Counterclaim is broader than set-off in that it not only defeats any recovery when the opposing claim is for a smaller amount but also permits the recovery of a single affirmative judgment against the opposing party for the difference between the amount of the counterclaim and the amount of the opposing party's claim. Counterclaims are not limited by the doctrine of "equitable set-off" specifically authorized by Section 68(a), but are recognized implicitly in Section 68(b), which states two circumstances in which neither set-off or counterclaim may be granted.

Thus a counterclaim may be utilized in an action brought by or on behalf of a bankrupt. As stated in *Collier on Bankruptcy*, (14th ed, 1967), ¶ 68.03, pp. 856-57:

> "There may be many types of claims which the defendant may wish to assert, not merely to offset the plaintiff's claim, or reduce or extinguish it, but with a view to obtaining affirmative relief thereon. Technically speaking, the term 'counterclaim' embraces the latter type and accordingly is broader than set-off or recoupment. . . .
>
> • • •
>
> "*There appears to be nothing in the* [*Bankruptcy*] *Act which eliminates the right to maintain such counterclaims.* Section 68(a) says nothing about counterclaim and appears to relate strictly to set-offs, as previously indicated. Nevertheless, Section 68(b) impliedly recognizes that counterclaims for affirmative relief may be maintained by stating certain conditions which curtail the right to assert a 'set-off *or* counterclaim' against the estate. *Thus in a suit in state court by a trustee, the court may be called upon to decide whether the defendant's plea may be sustained either as a right of counterclaim under state law (subject to the restrictions of Section 68(b))* or a right of set-off under Section 68(a)." (Emphasis added.)

There is no question that Brunswick's counterclaim for a deficiency balance due on the bankrupt's contract was a proper permissive counterclaim under Rule 13(b) of the Federal Rules of Civil Procedure. Counterclaims, whether permissive or mandatory, are maintainable under Rule 13(b), and a bankruptcy court is authorized to give judgment for recovery of the counterclaim if the negative provisions of Section 68(b) of the Bankruptcy Act are inapplicable. *Inter-State National Bank of Kansas City* v.

Luther, 221 F.2d 382, 390 (10th Cir., 1955), cert. granted, 350 U.S. 810, dismissed under Rule 60, 350 U.S. 944. Therefore, Brunswick's counterclaim was properly asserted under the Federal Rules irrespective of whether it can be sustained as an equitable or statutory set-off.

On facts similar to those here the Court of Appeals for the Fifth Circuit has held that a creditor's counterclaim for sums due on open account is maintainable in a suit for damages for conversion brought by a debtor who subsequently became bankrupt. In *Major Appliance Company, Inc.* v. *Gibson Refrigerator Sales Corporation*, 254 F.2d 497 (5th Cir. 1958), the creditor had converted some property belonging to his debtor. The debtor brought suit against the creditor for conversion, and the creditor counterclaimed for money due on several accounts owed by the debtor, including some that had no connection with the converted property. Subsequently the debtor went into bankruptcy. The District Court first dismissed the creditor's counterclaims and next held that the creditor was not guilty of conversion. On appeal the Court of Appeals reversed both rulings, holding that the creditor was guilty of conversion as a matter of law but that the District Court erred in dismissing the creditor's counterclaims. The court stated (254 F.2d at 502):

> "We hold further that the District Court should hear [the creditor's] counterclaims on their merits, as to which we express no opinion. Doubtless [the creditor] had the option of asserting the counterclaims in this action or of proving them as claims in the bankruptcy court. It would be inequitable and, in our opinion, in derogation of Rule 13, F.R.Civ.P. to proceed in this plenary action without according [the creditor] the right to assert its counterclaims in the same proceeding if it should desire."

Similarly in *Morris* v. *Windsor Trust Co.*, 213 N.Y. 27, 106 N.E. 753 (1914), the New York Court of Appeals, through Cardozo, J., held that a counterclaim might be asserted against amounts claimed for conversion as long as the counterclaim was permissible under the New York Code of Civil Procedure, as the counterclaim here is by the Federal Rules of Civil Procedure.

Here, after Olympic sued Brunswick for conversion, Brunswick counterclaimed for a deficiency balance for goods sold to Olympic. Olympic subsequently went into bankruptcy. The District Court did what the Fifth Circuit ordered in the *Major Appliance* case just discussed; it then allowed the respective claims of Brunswick and Olympic to continue to a single judgment, treating them as proper counterclaims against each other under Rule 13.

The only statutory restrictions on the right of counterclaim are those contained in Section 68(b). Brunswick's right to assert its counterclaim is not prohibited under Section 68(b), since the conversion occurred more than one year prior to Olympic's bankruptcy and Brunswick had received no void or voidable preference. Therefore, the District Court properly allowed the summary judgment entered on Brunswick's counterclaim to defeat the smaller jury verdict entered against Brunswick on Olympic's claim for damages for conversion. The entry of only one judgment in favor of Brunswick was proper under Rule 13 and Section 68(b), and should not have been reversed by the Court of Appeals. The failure of that Court to recognize the proper scope of the counterclaim rule and to give effect to that rule under the Bankruptcy Act presents a procedural issue of importance which should be decided by this Court.

CONCLUSION

For the above reasons, this petition should be granted.

Respectfully submitted,

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APPENDIX

APPENDIX

In The

UNITED STATES DISTRICT COURT
Eastern District of Tennessee
Southern Division

CIVIL 4820

BRUNSWICK CORPORATION,

Plaintiff,

v.

HOWELL CLEMENTS, TRUSTEE IN BANKRUPTCY FOR OLYMPIC LANES, INC.; OLYMPIC LANES, INC., and LESLIE B. JACKSON,

Defendants.

ORDER
(Filed April 7, 1969)

This cause came on to be further heard on the 3rd and 4th days of March, 1969, upon the pending motions, the pleadings, the pre-trial order entered May 10, 1968 and the entire record in the cause, from all of which it appeared to the Court as follows:

1. Summary judgment has heretofore been entered on February 14, 1967, in favor of the plaintiff, Brunswick Corporation, upon its original complaint in this cause, sustaining its replevin of the property described therein;

2. Partial summary judgment has heretofore been entered on March 26, 1968, (a) dismissing the counter-claim of Leslie B. Jackson against Brunswick Corporation, (b) dismissing the counter-claim of Olympic Lanes, Inc., against Brunswick Corporation for alleged violations of the Sherman Anti-Trust Act, and (c) striking and deleting the defense of usury alleged by Olympic Lanes, Inc., in defense of the claim of Brunswick Corporation for a deficiency judgment against Olympic Lanes, Inc. in the amount of Three Hundred Twenty-four Thousand and Six Dollars and 43/100 ($324,006.43) plus attorneys' fees, there being no issue as to any material fact relative to any of the foregoing matters;

[fol. 2] 3. On November 14, 1967, a voluntary petition in bankruptcy was filed by Olympic Lanes, Inc., and by order entered in this cause on December 19, 1967, Howell W. Clements, Trustee in Bankruptcy for Olympic Lanes, Inc., was substituted for Olympic Lanes, Inc., as a party in this action.

4. There is no dispute as to any material fact with respect to the right of Brunswick Corporation to a deficiency judgment against Olympic Lanes, Inc., for the sum of Three Hundred Twenty-four Thousand and Six Dollars and 43/100 ($324,006.43), plus attorneys' fees, it being stipulated by the parties that the unpaid balance of the debts owed by Olympic Lanes, Inc. to Brunswick Corporation under the contracts sued on in the amount of Three Hundred Twenty-four Thousand and Six Dollars and 43/100 ($324,006.43), and the only issue remaining with respect to said claims being the amount which Brunswick Corporation is entitled to recover from Olympic Lanes, Inc. as attorneys' fees, which issue, by agreement of the parties was submitted to the Court for its determination

without the intervention of a jury, and the Court, by its order entered March 4, 1969, has fixed the amount of said attorneys' fees at Thirty Two Thousand Four Hundred Dollars and 64/100 ($32,400.64).

5. The remaining issues in this cause came on for trial on March 3 and March 4, 1969, before the Court and a jury, and at the conclusion of the proof introduced by the Counter-plaintiff, Olympic Lanes, Inc., the Court sustained the motion of the counter-defendant, Brunswick Corporation, for a directed verdict on all issues in said counter-claims except the issue of whether or not Brunswick Corporation wrongfully converted to its own
[fol. 3] use personal property owned by Olympic Lanes, Inc., which issue, at the conclusion of all the evidence was submitted to the jury, and the jury rendered its verdict on said issue in favor of the counter-plaintiff, Olympic Lanes, Inc., and against the counter-defendant, Brunswick Corporation, and fixed the amount of damages at Forty Thousand Dollars ($40,000.00).

In accordance with all of the foregoing it is ORDERED, ADJUDGED and DECREED by the Court as follows:

1. That Leslie B. Jackson as a counter-plaintiff, take nothing of the counter-defendant, Brunswick Corporation, and that Brunswick Corporation take nothing of the said Leslie B. Jackson.

2. That the original plaintiff, Brunswick Corporation, have and recover of Howell Clements, Trustee in Bankruptcy for Olympic Lanes, Inc. the sum of Three Hundred and Fifty-six Thousand Four Hundred and Seven Dollars and 07/100 ($356,407.07), representing the balance of Three Hundred and Twenty Four Thousand and Six Dollars and 43/100 ($324,006.43) due on notes and contracts, plus attorneys' fees of Thirty Two Thousand Four Hundred Dollars and 64/100 ($32,400.64).

3. That the counter-plaintiff, Howell W. Clements, Trustee in Bankruptcy for Olympic Lanes, Inc., have and recover of the counter-defendant, Brunswick Corporation, the sum of Forty Thousand Dollars ($40,000.00).

4. That the respective judgments be set-off, with the result that the original plaintiff, Brunswick Corporation, have and recover of Howell Clements, Trustee in Bankruptcy for Olympic Lanes, Inc., the net sum of Three Hundred Sixteen Thousand Four Hundred and Seven Dollars and 07/100 ($316,407.07).

5. That the costs of this action be taxed one half against Howell Clements, and the other one half is taxed against the Trustee in Bankruptcy for Olympic Lanes, Inc. See *U. S.* v. *Jno A. Johnson & Sons* 111 F.Supp. 785, 87 *Clark Bros. & Co.* v. *Pou* 20 F.2d 74 *Cumberland Glass Co.* 237 U.S. 447.

Enter:

(*signature illegible*)

.....

United States District Judge

Approved:

Spears, Moore, Rebman & Williams

By: *Thomas S. Kale*

Attorneys for Brunswick Corporation

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By: .....

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OPINION OF THE COURT OF APPEALS
(Filed in Court of Appeals April 17, 1970)

No. 19689

UNITED STATES COURT OF APPEALS
For the Sixth Circuit

Brunswick Corporation,

Plaintiff-Appellee,

v.

Howell W. Clements, Trustee In Bankruptcy for Olympic Lanes, Inc.,

Defendant-Appellant.

On Appeal from the United States District Court, Eastern District of Tennessee, Southern Division.

Decided April 17, 1970

Before: PHILLIPS, *Chief Judge,* PECK and BROOKS, *Circuit Judges.*

BROOKS, *Circuit Judge.* This is an appeal by the trustee in bankruptcy for Olympic Lanes, Inc., from an order allowing an equitable setoff. The bankrupt estate was indebted to the defendant-appellee, Brunswick Corporation, in the sum of approximately $300,000. The trustee obtained a $40,000 judgment against Brunswick for conversion and the District Court permitted this judgment to be setoff and deducted from the $300,000 indebtedness owed Brunswick. The only issue is whether the setoff should have been allowed.

In August, 1961, Olympic Lanes, Inc., purchased from Brunswick on conditional sales contracts a number of bowling lanes and pinsetters. Subsequently, Olympic encountered serious financial difficulties and was unable to keep its payments current. Brunswick granted several extensions but after August, 1965, no further payments on the defaulted contracts were received. More than a year later, a replevin action to foreclose the security under the conditional sales contracts was filed, and on September 9, 1966, Brunswick took possession and began operating the complete bowling establishment.

In the replevin action, Olympic admitted default but raised several defenses and counterclaimed for damages. The damages sought were for conversion of certain personal property that Brunswick took over when it moved in and began operating the bowling establishment. In 1967 the foreclosure sale was held and Brunswick bid in its equipment and filed a claim for $324,006.43 to recover the deficiency that resulted from the sale. On November 14, 1967, Olympic Lanes filed a voluntary petition in bankruptcy.

Two years later, in 1969, Brunswick was finally granted judgment for the deficiency on the foreclosure sale and for attorneys' fees, and a jury returned a verdict for the trustee and against Brunswick for $40,000 on the conversion issue. The $40,000 judgment for all intents and purposes appeared to be the only asset in the bankrupt's estate. These were the circumstances under which the setoff was ordered by the District Court.

The only issue is whether a conversion judgment against a creditor of the bankrupt can be setoff from money owed the creditor by the bankrupt which arose under a contract.

Section 68(a) of the Bankruptcy Act (11 U.S.C. § 108) provides that:

> "a) In all cases of mutual debts or mutual credits between the estate of a bankrupt and a creditor the account shall be stated and one debt shall be set-off against the other, and the balance only shall be allowed or paid."

The phrasing of Section 68(a) might seem to require an interpretation that setoffs in bankruptcy are mandatory when mutual debts or mutual credits exist. However, this is clearly not the case. In *Cumberland Glass Manufacturing Co.* v. *De Witt*, 237 U.S. 447 (1914), the Supreme Court, referring to what now is Section 68(a), stated:

> "The provision is permissive rather than mandatory, and does not enlarge the doctrine of set-off, and cannot be invoked in cases where the general principles of set-off would not justify it."

See also: *Monongahela Rye Liquors, Inc.*, 141 F.2d 864 (3rd Cir. 1944); *Prudential Ins. Co. of America* v. *Nelson*, 101 F.2d 441 (6th Cir. 1939), cert. denied, 308 U.S. 583 (1939); *Stanolind Oil & Gas Co.* v. *Logan*, 92 F.2d 28 (5th Cir. 1937), cert. denied, 302 U.S. 763 (1937); *Lehigh Valley Coal Sales Co.* v. *Maguire*, 251 F. 581 (7th Cir. 1918).

Moreover, while the right of setoff is discretionary in the bankruptcy court, *Prudential Ins. Co. of America* v. *Nelson, supra; Tuscon House Construction Co.* v. *Fulford*, 378 F.2d 735 (9th Cir. 1967), the court must exercise its discretion under the general rules and principles of equity. *Scott* v. *Armstrong*, 146 U.S. 499 (1892); *In Matter of Rosenbaum Grain Corp.*, 103 F.2d 656 (7th Cir. 1939).

Thus, where justice and equity dictate that a setoff be denied, it must be. See e.g.'s: *In Matter of Garfunkel and Tauster,* 8 F.2d 790 (1924); *Burnes National Bank* v. *Mueller-Keller Candy Co.,* 86 F.2d 252 (8th Cir. 1936); *Clark Bros. & Co.* v. *Pou,* 20 F.2d 74 (4th Cir. 1927); *Hitchcock* v. *Rollo,* Fed. Case No. 6, 535 (C.C.Ill. 1872). In light of this long standing interpretation of Section 68(a) that setoffs are only permissive and must be granted or denied in accordance with equitable rules, it follows that the contention of Brunswick that the District Court had no choice but to grant the setoff must be rejected.

Brunswick further argues Section 68(a) contemplates setting off tort claims against contract claims and, therefore, the setoff in this case was proper. However, a tort claim is not automatically setoff against contract claims. Collier on Bankruptcy, while recognizing that a split of authority on this question exists, maintains that generally the "better view would seem to be that under section 68 tort claims may be set-off against contract or vice versa." Collier on Bankruptcy, 14th Ed. § 68.04 (3) pp. 878-880. But cf. Remington on Bankruptcy, § 1557 pp. 425-427. But even Collier distinguishes between different types of torts and acknowledges that liability for willful conversion may not be setoff against monies owing the converter by the bankrupt. Collier on Bankruptcy, 14th Ed. § 68.04 (3) p. 880 nn. 50, 56.

Brunswick cites three cases contending they support the proposition that conversion liability may be setoff against contract claims. In the first case, *Milkman* v. *Bishop, McCormick & Bishop,* 18 N.Y.S.2d 7 (1940), the bankrupt converted an encumbered automobile belonging to the defendant. In the present case, it is not the bankrupt who converted the property, but rather it is the

creditor of the bankrupt. This points to a significant distinguishing aspect between the two cases. A creditor who converts the property of a bankrupt, if his conversion liability is simply setoff against his claim, would receive a larger share of the bankrupt's estate than if he were to share on a pro rata basis with the other creditors. When the bankrupt is the converter, no such incentive exists. In the second case cited by Brunswick, *Phillips* v. *Baker*, 165 F.2d 578 (5th Cir. 1948), the same situation existed. That is, the bankrupt was the converter.

The last case cited by Brunswick is *In re Solmon Weed & Co.*, 53 F.2d 335 (2nd Cir. 1931). There a stockbroker repledged certain stock it purchased for the bankrupt on margin. The Court, after a lengthy analysis, concluded that the repledging was a conversion and that, while the bankrupt was entitled to damages for conversion, the converter had a right to recoup to the extent of the amount it loaned the bankrupt for margin purposes. In the present case, there is no question of recoupment; rather we are dealing with a setoff. The two procedures are different in substance if not in the end result they produce. Thus, while recoupment is the setting up of a demand for reduction or abatement of the plaintiff's claim, it must arise out of the very same transaction and if any excess amount is still owing, it cannot be asserted. A setoff, on the other hand, is generally employed when different transactions are involved, and the defendant may be entitled to any excess over plaintiff's claim. See Collier on Bankruptcy, 14th Ed., § 68.03, pp. 854-855. In addition, the basic equity of allowing a reduction of a claim which arises from the same transaction is more persuasive than when the claims arise from entirely different transactions.

Furthermore, there is a line of cases which hold that a setoff should not be allowed when the creditor wishes to

setoff its conversion liability to the bankrupt against a debt owed the creditor by the bankrupt. See *Western Tie & Timber Co.* v. *Brown*, 196 U.S. 502 (1905); *Arkansas Fuel Oil Co.* v. *Leish*, 133 F.2d 79 (5th Cir. 1943); *Brislin* v. *Killanna Holding Corp.*, 85 F.2d 667 (2nd Cir. 1936); *In re Lyhens Hosiery Mills Inc.*, 141 F. Supp. 891 (S.D. N.Y. 1956); *Howard* v. *Mechanics' Bank*, 262 F. 699 (E.D. N.Y. 1920); *McCabe* v. *Winship*, Fed. Case No. 8, 668 (D.C. Minn. 1877); *McQueen* v. *New*, 86 Hun. 271, 33 N.Y. Supp. 395 (1895); *Shield* v. *Cartwright*, 172 S.W.2d 108, affd. 142 Tex. 324, 177 S.W.2d 954 (1944). The holding of these cases is that a creditor of a bankrupt should not be permitted to pay himself through the device of setoff by converting the bankrupt's property, particularly at a time when he knows of the bankrupt's insolvency.

In the present case Brunswick, before August, 1965, had given Olympic several extensions of time for payment on the conditional sales contracts. In August, 1965, the last extension was given and at that time Olympic had not made a payment for more than a year. When Brunswick took possession of the bowling establishment, it had to make arrangements with the landlord who also had not been paid his rent by Olympic for a number of months. Under these circumstances, Brunswick could only have concluded that Olympic was insolvent when possession was taken of the bowling establishment and certain of Olympic's personal property was converted. In fact, in Brunswick's brief on this appeal, it is admitted that when possession was taken of the bowling establishment, it was to operate it until "the equipment might be resold to a solvent and credit-worthy purchaser." The fact that it was a year after the conversion that Olympic filed bankruptcy does not detract from the point that for two and one-half years before bankruptcy Olympic was hopelessly insol-

vent and in default on the Brunswick contracts, to say nothing of being several months in arrears on the rent for the building it occupied.

Some mention is made of the four month preference period in several of the cases which recite the rule disallowing the converter's liability from being setoff from a debt owed the bankrupt, see *Western Tie & Timber Co.* v. *Brown, supra; Arkansas Fuel Oil Co.* v. *Leish, supra.* However, it is clear that it is equity which dictates the rule and not that the conversion liability is treated as if it were a "voidable preference."

The order granting the setoff is vacated and we remand for further proceedings consistent with this opinion.

JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT.

(Filed in Court of Appeals April 17, 1970)

APPEAL from the United States District Court for the Eastern District of Tennessee.

THIS CAUSE came on to be heard on the record from the United States District Court for the Eastern District of Tennessee and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby vacated and the case remanded for further proceedings consistent with the opinion.

It is further ordered that Defendant-Appellant recover from Plaintiff-Appellee the cost on appeal, as itemized below, and that execution therefor issue out of said District Court.

Entered by order of the Court.

Carl W. Reuss,
Clerk.